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ON

SECURITIES AND EXCHANGE COMMISSION
REGULATION FAIR DISCLOSURE
(17 C.F.R. PART 243)
"REG FD"

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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Executive Summary of Testimony of Patrick D. Sweeney

1. **A widespread, ongoing practice of selective disclosure of *material* information by corporate issuers would erode public confidence in the fairness of the securities markets and should be corrected by an appropriate regulatory response.**

2. **The broad scope of Reg FD is premised upon the existence of widespread and abusive selective disclosure of *material* information by corporate issuers.**

3. **In assessing whether Reg FD appropriately responds to the problem of abusive selective disclosure, consideration should be given to the potentially adverse impact of the regulation upon the long established investor relations communication channels that support the fundamental analysis conducted by buy-side investment managers.**

4. **By persistently linking the rationale and methodology of Reg FD to insider trading concepts, the Commission appears to have provoked a conservative and overly cautious response on the part of corporate issuers to regulatory compliance.**

5. **Reg FD has already affected the quantity and timeliness of information provided by corporate issuers, and the adverse impact of the regulation on the fundamental analysis process may progressively worsen as analytical investment models become outdated.**

6. **The negative impact of Reg FD on market transparency is most apparent in the case of financially stressed or distressed corporate issuers.**

7. **Reg FD should be reevaluated generally, taking into account the empirical data employed by the Commission in determining the scope of the selective disclosure problem, as well as the potential detrimental impact of the regulation on the buy-side fundamental analysis process and other legitimate market processes.**

8. **Public disclosure requirements imposed on corporate issuers by Reg FD should be based upon the objective itemized reporting methodology of Section 13(a) of the Securities Exchange Act, rather than upon subjective and ambiguous determinations of materiality similar to those employed in determining liability for insider trading under Rule 10b-5.**

Introduction

My name is Patrick D. Sweeney. I am the General Counsel of Nomura Corporate Research and Asset Management Inc., more commonly known as "NCRAM". NCRAM is a registered investment adviser based in New York City. It is a member of the Investment Company Institute, the national association of the American investment company industry. NCRAM manages client assets invested in high yielding corporate bonds and other securities issued and traded in the U.S. capital markets. At February 28, 2001, NCRAM managed client assets with an aggregate market value of approximately $2.3 billion. A significant portion of NCRAM's clients are mutual funds organized and sold to retail investors in the United States and other major capital markets. While mutual funds themselves are correctly viewed as institutional investors, they are typically offered to the public retail investor markets and draw capital investments from millions of retail investors.

Like many other "buy-side" investment managers, NCRAM employs its own team of research analysts to support all investment decisions made by NCRAM on behalf of its advisory clients. Such "buy-side analysts" should be distinguished from "sell-side research analysts" employed by investment banks, broker-dealer firms and similar institutions to provide research and analytic support for corporate investment banking engagements, investment recommendations to firm customers, and related functions. By contrast, as a buy-side investment manager, NCRAM works solely for its advisory clients and continually engages in a fundamental analysis of the business and financial risk of

each corporate issuer in which it has invested or proposes to invest on behalf of its advisory clients. As part of this fundamental analysis, NCRAM evaluates the issuer's management experience, market position, cost structure, historical track record and cash flow generating ability. The process regularly undertaken by NCRAM's analysts involves not only a review of the company's published financial information, but also incorporates one-on-one visits with company management, discussions with industry analysts, visits to company facilities and consultation with third party experts as appropriate.

The ability of NCRAM, and of many other buy-side investment managers, to conduct fundamental investment analysis is a key variable in the quality of investment services provided to retail investors in mutual fund advisory accounts. Fundamental analysis on behalf of mutual funds provides a significant investment benefit which most retail investors would be unable to achieve with their own resources.

Comments

It is from these perspectives that I am pleased to have the opportunity today to make the following comments on Reg FD:

1. **A widespread, ongoing practice of selective disclosure of *material* information by corporate issuers would erode public confidence in the fairness of the securities markets and should be corrected by an appropriate regulatory response.** Buy-side investment managers recognize the importance of Commission rule-making and enforcement

efforts under Section 10(b) of the Securities Exchange Act of 1934 to prevent the misuse of material non-public information in the public securities markets. Registered investment advisers are specifically obliged, under Section 204A of the Investment Advisers Act of 1940, to prevent the misuse of material non-public information in their possession. With these concerns in mind, the protocols of investor relations communications between corporate issuers and buy side investment managers have been carefully structured over the years to limit communications to *non-material* information, which can be used by buy-side analysts to structure proprietary investment models for corporate issuers. This practice is consistent with the long-recognized "mosaic theory," which enables an investment manager to develop and implement independent investment decisions based upon its analysis of discrete, non-material pieces of information provided by the corporate issuer.

2. **The broad scope of Reg FD is premised upon the existence of widespread and abusive selective disclosure of *material* information by corporate issuers.** In determining whether Reg FD is an appropriate regulatory response to the problem, it would be helpful to understand more clearly the empirical data supporting this premise, none of which was included in the proposing and adopting releases.

3. **In assessing whether Reg FD appropriately responds to the problem of abusive selective disclosure, consideration should be given to the potentially adverse impact of the regulation upon the long established**

investor relations communication channels that support the fundamental analysis conducted by buy-side investment managers. Although the adopting release refers several times to the role of analysts in the selective disclosure regime under question by the Commission, it is clear from the context that the Commission is referring to sell-side analysts responsible for securities recommendations. It is troubling that a regulation with such a potentially intrusive impact upon the long established communication channels between corporate issuers and buy side investment managers would be promulgated in the absence of a thorough examination of the potential ramifications for the fundamental analysis process and for the mutual fund investors who benefit from it.

4. **By persistently linking the rationale and methodology of Reg FD to insider trading concepts, the Commission appears to have provoked a conservative and overly cautious response on the part of corporate issuers to regulatory compliance.** Despite the repeated disclaimers of the Commission and several of its staff members, the adopting release repeatedly links the rationale for Reg FD to insider trading theories, stating, for example, that the "economic effects of the two practices are essentially the same," and prominently citing comment letters from individual investors to the effect that "selective disclosure was indistinguishable from insider trading in its effect on the market and investors". Even more significantly, the Commission has discarded the methodology of itemized reporting requirements under Section 13(a) of

the Securities Exchange Act (under which statutory provision the regulation is theoretically promulgated) in favor of a Rule 10b-5-like standard of accountability for disclosure of "material" information, whatever that may turn out to be in hindsight. Predictably, corporate issuers have determined, with the support of their counsel, to err on the side of discontinuing or truncating communications with analysts, particularly on a "one-on-one" basis.

5. **Reg FD has already affected the quantity and timeliness of information provided by corporate issuers, and the adverse impact of the regulation on the fundamental analysis process may progressively worsen as analytical investment models become outdated.** Although one-on-one calls and group investor calls continue, less information is provided, and in a less timely manner. Corporate issuers have traditionally assisted buy-side analysts in the construction of investment models for the issuers by providing historic "building block" components of revenue, expense and margin data, none of which would be considered material non-public information at the time the issuer shared it with the analyst. In our experience, a significant number of corporate issuers have either discontinued or curtailed this practice since the promulgation of Reg FD. We attribute that interruption of information flow to the expansive emphasis by the Commission on the abuses of earnings guidance, and the resulting fear of corporate issuers that selective disclosure of any information used by analysts to construct earnings models may

subsequently be required to be disclosed publicly. Regardless of the reason, the inability of analysts to refresh their investment models from time to time with more current historical information of this nature (or to create new models for new issuers) will inevitably impact the quality of fundamental analysis performed for mutual fund clients.

6. **The negative impact of Reg FD on market transparency is most apparent in the case of financially stressed or distressed corporate issuers.** Well managed, financially stable corporate issuers have generally attempted to cope with Reg FD restrictions in the context of one-on-one meetings and other traditional means of investor relations communications. In striking contrast, however, financially stressed and distressed companies generally appear to have shut down communications channels with buy-side investment managers, citing "Reg FD restrictions". In many cases the financially troubled company refrains from communicating with the capital markets in any manner until the company actually defaults on its debt or files for bankruptcy. Quite predictably, the capital markets operate to punish this lack of transparency by devaluing the company's publicly traded securities and further reducing the financial flexibility of the company to resolve its problems outside of bankruptcy. While it would not be fair to blame the current dramatic increase in corporate defaults and bankruptcies on Reg FD, it is nonetheless evident that many managers of financially troubled companies have relied upon

the ambiguities in the regulation to avoid accountability to buy-side investment managers, at significant cost to the companies' investors.

Recommendations

1. **Reg FD should be reevaluated generally, taking into account the empirical data employed by the Commission in determining the scope of the selective disclosure problem, as well as the potential detrimental impact of the regulation on the buy-side fundamental analysis process and other legitimate market processes.** Providing retail investors with more direct access to corporate earnings guidance is of course a positive development. However, a regulation which achieves this result by inhibiting the construction of investment models used to benefit the mutual fund investor must be seriously examined.

2. **Public disclosure requirements imposed on corporate issuers by Reg FD should be based upon the objective itemized reporting methodology of Section 13(a) of the Securities Exchange Act, rather than upon subjective and ambiguous determinations of materiality similar to those employed in determining liability for insider trading under Rule 10b-5.** This recommendation was developed in detail in the comment letter of the Investment Company Institute dated April 27, 2000, a copy of which is attached hereto, to which NCRAM and numerous other members of the investment management community contributed. Such a

revision of Reg FD would give corporate issuers clear guidance as to permissible areas of private discussion with buy-side analysts and should eliminate the *in terrorem* impact of the regulation.

Conclusion

NCRAM appreciates this opportunity to testify before the Subcommittee. Reg FD is a laudable effort of the Commission to maintain investor confidence in the integrity of the securities markets. More work is needed, however, to ensure that the scope of the regulation does not produce unintended and detrimental marketplace consequences. We are prepared, in collaboration with the Investment Company Institute and many of its other members, to continue to work with the Congress and the Commission to achieve the proper balance of market efficiencies and regulatory constraints with respect to the issue of selective disclosure.